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International Economic & Energy Weekly

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Comments and queries regarding this publication are welcome. They may be directed to Directorate of Intelligence, 25X1 [redacted] 25X1

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Synopsis

1 **Perspective—West European Trade Outlook: Rethinking Policies** [redacted] 25X1

We believe Western Europe's international trade performance will deteriorate significantly during the next two to three years, impacting negatively on prospects for economic growth, relations with trade partners, and the EC's negotiating flexibility at the GATT Round. We believe the EC, over the next several years, will attempt to move ahead on internal and external trade liberalization—but if either fails, the EC will increasingly turn to protectionist policies. [redacted] 25X1

3 **West European Trade Outlook: EC Motivations in the GATT Round** [redacted] 25X1

Although the EC and the United States share a desire for enhanced competitiveness, the pace of the Uruguay Round trade negotiations in the coming year will be increasingly slowed by sharp EC-US differences over negotiating strategies, the Community's political need to match its GATT concessions with its own internal market reform schedule, and competing member aims versus overall EC policy objectives. [redacted] 25X1

7 **USSR: Holding Fast to the 12th Five-Year Plan** [redacted] 25X1

The Soviet economy, after a surge in 1986, this year has fallen well short of Mikhail Gorbachev's ambitious goals of accelerating economic growth while—at the same time—modernizing the USSR's industrial plant and equipment. Unless some adjustments are made to give the economy time to adjust to the wide-ranging changes being implemented, Gorbachev's efforts to simultaneously modernize the economy and step up the rate of economic growth are likely to continue to undermine each other. [redacted] 25X1

11 **Japan: Fiscal Bonanza From NTT Stock Sale** [redacted] 25X1

Tokyo's gradual selloff of 10.4 million shares of NTT stock by 1989 is providing substantial short-term gains to the government, which is using the revenues from the privatization of the world's largest telecommunications firm to help stimulate domestic demand and retire government debt. We believe longer term risks—particularly increased volatility on the Tokyo stock market—may, however, overshadow current benefits. [redacted] 25X1

15 **Japan: NTT Operating in a New Environment** [redacted] 25X1

NTT is responding to the end of its monopoly and privatization by making a major effort to integrate information services and to explore such diverse ventures as computer security and car rentals. Nevertheless, NTT's newfound requirement to carefully protect its bottom line has not led it to procure equipment from abroad. [redacted] 25X1

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Perspective

West European Trade Outlook: Rethinking Policies [redacted] 25X1

We believe Western Europe's international trade performance will deteriorate significantly during the next two to three years, impacting negatively on prospects for economic growth, relations with trade partners, and the EC's negotiating flexibility at the GATT Round. Community trade policies will continue to be driven by strong European currencies, high unemployment, and the relatively slow start EC members have made at structural adjustment. The Community's real net exports have been declining steadily since the second quarter of 1985, and in 1988 are expected to fall by a further $55 billion (in 1980 prices), roughly equal to 1 percent of real GDP, helping to whittle down real economic growth to about 2 percent. This, plus a heavy dependence on imports of Japanese technologies and related investment, will probably lead EC officials toward new protectionist policies and the negotiation of more market-sharing arrangements. The result probably will be additional constraints on economic growth and a further tarnished image for the EC as a leader in the free-world economy. [redacted] 25X1

Defensive responses will almost certainly focus on creation of additional bilateral protectionism targeted at Japan. EC officials have concluded that Japan's export offensive during 1986-87 against the EC, concentrated in motor vehicles and parts and in several key high technology commodities, is overpowering existing protectionist policies. Consequently, we expect that the Community's rising dependence on Japan will lead to stiffer EC policies on imports and on Japanese investment in assembly factories, and this will further reduce the EC's competitiveness. [redacted] 25X1

We believe EC-US trade relations also will become more difficult. Disagreements over specific commodity issues—agricultural products, aircraft, and telecommunications—and market-sharing arrangements (a euphemism for cartels) will dominate the relationship. Most EC-US trade disputes probably will continue to be intense because weaknesses in GATT's dispute settlement procedures leave both sides with no effective alternative to bilateral confrontations. In response to US leadership, however, Community expectations and preparations for the Uruguay Round have escalated considerably during recent months. While the EC will be forced to begin negotiating in 1988, it will try to delay early agreements and may be tempted to await the arrival of the new US administration in 1989 before beginning to negotiate in earnest. The primary short-term risk is that, if the United States eventually adopts what the West Europeans perceive as a watered-down but still protectionist trade law, the EC will most certainly fulfill its promise to retaliate in kind and, in doing so, possibly stall the Uruguay Round negotiations. [redacted] 25X1

EC trade-related conflicts with the LDCs probably will grow significantly, limiting export income in the indebted countries and prolonging resolution of the global debt crisis. These countries' shares of EC trade have declined rapidly during the

1980s, and we believe further reductions are probable. In particular, we expect EC imports from these countries to be weak because they compete with EC producers in some commodities such as steel, and LDCs do not produce the higher quality manufactured goods preferred in the EC. On the export side, lagging Community product competitiveness in developed-country markets is likely to cause the EC to develop further its trade with the Third World. In the GATT Round, the EC will be extremely reluctant to grant any concessions to the LDCs without obtaining reciprocal benefits. 25X1

We believe, however, that the EC's international competitiveness, relative to that of the United States and Japan, will improve significantly over the long term as the result of EC market liberalization. The EC's GATT policies will depend in large part on its success in creating an internal market—involving eventual elimination of nearly all remaining internal EC nontariff barriers to trade. Although the EC is falling behind its goal for completion by 1992, we believe the Community will continue to make measurable progress. As EC firms become more efficient in order to compete within the EC, the Community will find it easier to make concessions in the Uruguay Round. 25X1

The primary long-term risk to the Community's economic and trade outlook is the possible loss of the political initiative to liberalize trade. This risk may be minimized somewhat because, barring an unexpected recession during 1988-89, global trade imbalances should gradually diminish and stabilize as a result of improved policy coordination among major countries. In addition, the recent stock market crash has convinced nearly all EC members that more effective structural adjustment policies are needed to facilitate the transition to reduced global external imbalances. Nevertheless, we believe a surge in EC protectionist policies cannot be ruled out if either internal market reform or the GATT Round becomes bogged down. 25X1

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West European Trade Outlook: EC Motivations in the GATT Round[1]

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Although the EC and the United States share a desire for enhanced competitiveness, the pace of the Uruguay Round trade negotiations in the coming year will be increasingly slowed by sharp EC-US differences over negotiating strategies, the Community's political need to match its GATT concessions with its own internal market-reform schedule, and competing member aims versus overall EC policy objectives. Agriculture, for which EC protectionist sentiments run high, poses the greatest challenge for US negotiators, although such issues as emergency import restraints, services, and dispute settlement also will prove difficult. The EC almost certainly will continue to press for market-sharing arrangements as an interim solution to freer markets and will retaliate strongly if the United States adopts what the EC perceives as a weaker but still protectionist trade law, possibly endangering the GATT Round itself.

EC's Approach

West European leaders are committed at the Uruguay Round to increasing the role of market mechanisms in their domestic and international markets. They view favorably the United States' initiative at the OECD to promote structural adjustment, having embarked on a program of deregulation and denationalization in their own markets. Moreover, the effects of the recent global stock market crash have heightened all OECD countries' awareness of the need for additional, coordinated structural adjustment policies. Although the EC and nearly all other major GATT members want to extend market liberalization internationally in order to improve their own competitive positions and increase their access to other markets, there is no agreement yet on common goals for GATT reform.

[1] This is the first in a series of articles that will assess the West European trade outlook. Other articles will cover the impact of exchange rate changes and trade relations with the United States, the LDCs, and Japan.

The Community's strong commitment to the Uruguay Round will not preclude the EC from working hard to prevent the United States from dominating the negotiations. While the EC has reacted positively to US leadership by accelerating its participation and will be forced to begin negotiating in 1988, it may want to delay committing to the United States on difficult issues as it awaits the arrival of the new US administration in 1989. In addition, the EC is likely to adjust its negotiating strategy to the progress made on contentious bilateral trade relations, particularly with Japan, the United States, and the LDCs. The pace also will be affected by the Community's linkage of its own internal market reforms—scheduled to be completed in 1992—with GATT agreements, and by its own concept of "globality," defined to mean parallel progress on all issues to achieve a balance of concessions. 25X1 25X1

The Community opposes the US desire to single out selected items now for a midterm agreement, before substantive negotiations have progressed further. It views the US attempts as premature, divisive, and likely to delay substantive work. In particular, the EC has been skeptical that sufficient progress can be made on this Round's new issues—services, intellectual property rights, and trade-related investment measures—to allow their inclusion in a midterm agreement. 25X1

The expected deterioration of the EC's trade performance during 1988 probably will limit the Community's GATT negotiating flexibility. However, we believe the market-oriented negotiating agendas of the 15 primary GATT negotiating groups will facilitate some interim agreements by the end of 1988, assuming substantive negotiations are well under way. The Community has viewed favorably work of the Functioning of the GATT System (FOGS) Committee and probably would support a midterm agreement incorporating some of the Committee's proposals along with interim results on several other areas. 25X1 25X1

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Major Issues

Domestic political priorities, institutional biases, and a sense of lagging the United States and Japan competitively will shape EC concessions on several issues of US concern. Consistent with its bilateral trade strategies, the EC is seeking to improve its access to foreign markets through negotiated market-sharing arrangements or cartels. Accordingly, we expect the EC to continue to press its pre-Uruguay Round arguments for expanded imports of EC goods by Japan, the NICs, and CEMA.

FOGS. Although the EC would be willing to select some of the FOGS Committee's proposals for an interim agreement, the Community would prefer, because of globality, that most of the work be performed at the end of the Round. It has been most interested in the issue of improvements in the linkages between international trade and monetary policies, an area that will require lengthy negotiations. Also, the Commission, at least, would like to limit the participation of trade ministers—except occasionally to give the negotiations direction—in order to minimize politicization. While the EC is willing to consider enhancing the existing trade policy surveillance system, it does not want to strengthen the legal clout of that system.

Agriculture. The EC is committed to negotiating major agricultural reforms, but is likely to obstruct these discussions occasionally and probably would never accept the full opening of its protected domestic market. As an opening gambit, the EC has proposed market-sharing arrangements to cut world grain surpluses and gradual reductions in farm subsidies on an unspecified timetable, while proposing, counter to GATT's standstill and rollback provisions, an end to duty-free entry into the EC of feed ingredients. Serious disagreements among the member states will hamper the EC's negotiating ability, although pressures to reform agriculture and address the EC's budget crisis will keep the Community at the negotiating table:

- France supports major subsidy cuts, as does the United Kingdom, but will almost certainly drag its feet on the issue until after the French presidential election next spring.
- Bonn, dependent on the farm vote, is even more reluctant to cut subsidies, preferring production quotas instead.

Meanwhile, the West Europeans doubt that even the United States can deliver on its proposed worldwide 10-year phaseout of all agricultural subsidies because of likely domestic political backlash. Consequently, the EC has concentrated its initial efforts on garnering credit for the limited Common Agricultural Policy reform and other structural adjustment measures already adopted as well as for its substantive contributions to other negotiating areas of the GATT Round. 25X1

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Safeguards. The Community's support for import restraints has intensified over the past year primarily because of EC fears about growing reliance on key Japanese high-technology products and investment. The EC wants to protect its struggling industries from external competition while it implements structural adjustment programs to help those industries become more competitive. Accordingly, the EC—which is isolated on this issue—places high priority on concluding an agreement that allows selective application of those safeguards so that its negotiating leverage with Japan is enhanced. 25X1

Services. The Community is seeking to advance its competitiveness with respect to the United States and Japan in the high-technology services industry, particularly in banking and insurance. The EC will continue to push for a binding agreement on services, but its negotiating positions are likely to be somewhat confused because of internal EC disagreements over negotiating tactics and the reluctance of key EC members—especially France—to allow the less competent Commission to negotiate for them in this area. While France and the United Kingdom probably will press the Commission for including services in a midterm agreement, the Commission is likely to move more slowly because of other member-country concerns about pacing EC-internal structural adjustments with GATT reforms. 25X1

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Intellectual Property Rights. The EC believes the problem of inadequate procedures and remedies in this area should be addressed as a priority matter while avoiding solutions that create barriers to legitimate trade. On the basis of its past efforts to block imports of counterfeit goods, the Community has proposed that the combating of counterfeiting and other forms of piracy be made the initial focus of negotiations. Consistent with its globality concept, the EC has been emphasizing the importance of bringing developing countries—especially the NICs—into the negotiations. Internal EC disagreements are reflected by France's pushing the EC to take a broader and more dynamic role in the negotiations, while Italy and West Germany have been disinterested.

Trade-Related Investment Measures (TRIMS). The EC has been moving slowly on TRIMS—such as local content requirements—because of internal disagreements concerning TRIMS' effects on LDCs and their debts. The French are supporting a broad mandate for TRIMS negotiations with the hope that the results of GATT negotiations can be used to encourage more comprehensive talks on investment later on. In contrast, the United Kingdom and West Germany have been moving slowly on TRIMS because of their fear—not shared by France—that the discouragement of export performance requirements may reduce the LDC debtors' debt-servicing capabilities. In addition, the United Kingdom is reluctant to give the Commission much negotiating authority on TRIMS.

Dispute Settlement. The Community will maneuver to maintain its options under any new dispute settlement procedure, an area of major weakness under current GATT rules. Consequently, although the EC nominally is open to improving the GATT's settlement mechanism, it continues to believe that those procedures must rely primarily on negotiation rather than adjudication.

Other Issues. EC positions in the other GATT committees probably will be guided by the trade-offs the Community feels it must make to reach a balance of concessions. For example, the EC will press the LDCs for greater trade liberalization in exchange for such possible GATT agreements as stronger GATT rules against agricultural subsidies, a non-country-specific safeguards code, or tightened dispute settlement rules. In addition, Japanese trade barriers probably will become a more contentious issue at the negotiations during 1988 as the Community presses Japan for market access benefits that will balance whatever concessions are offered by the EC. 25X1

Outlook

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Although the EC may slow the pace of GATT talks at various times to achieve a Community consensus, it will remain committed to concluding a comprehensive trade agreement. The pace probably will slow as issues become more sharply defined and as the US agenda comes into conflict with the EC's requirement for internal consensus. The adoption of a US trade law, perceived by the West Europeans as weaker but still protectionist, would most certainly result in EC retaliation, possibly precipitating a major rupture of the Uruguay Round. EC Trade and External Relations Commissioner De Clercq has already informed US officials that many measures in the proposed trade bill are not acceptable to the Community.

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A failure of the Round to adopt the EC's desired market-sharing arrangements would probably cause the EC to assume an even more defensive posture. An economic recession in major countries during 1988-89, more of a possibility as a result of the recent turmoil in financial markets, probably would cause the Community to pull back from negotiations as members seek to protect their own markets. Any major unexpected delay in the planned completion in 1992 of the EC's internal market would cause the Community to delay its approval of GATT reforms under which it believed it could not yet be competitive. 25X1

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USSR: Holding Fast to the 12th Five-Year Plan 25X1

The Soviet economy, after a surge in 1986, this year has fallen well short of Mikhail Gorbachev's ambitious goals of accelerating economic growth while—at the same time—modernizing the USSR's industrial plant and equipment. Although not without its bright spots, the economy is sputtering again this year as the leadership struggles to implement seemingly contradictory economic programs. Still, the Kremlin has not backed off the high targets for 1986-90. Unless some adjustments are made to give the economy time to adjust to the wide-ranging changes being implemented, Gorbachev's efforts to simultaneously modernize the economy and step up the rate of economic growth are likely to continue to undermine each other. 25X1

Holding Fast to the Plan

The performance of the economy during the first two years of the current five-year planning period generally has fallen short of leadership goals. Nonetheless, information on the 1988 economic plan indicates that 1986-90 plan targets have not been lowered. The plan for next year implies, for example, that GNP and industrial output are to rise by 4 percent and 4.5 percent, respectively, over this year's plan targets—in line with the 1986-90 goals but roughly double the average annual rates of growth posted so far. In addition, some new, even more ambitious, tasks have been added. The leadership, for example, has raised markedly goals for productivity gains and resource conservation. Meanwhile, enterprise managers are being directed to increase the use of second and third shifts at their plants and to place greater emphasis on technological advances. 25X1

Consumer Spending. A major feature of the 1988 plan is the increased emphasis given to the consumer. The 12th Five-Year Plan already contained impressive targets for improving the lot of the consumer. For example, output of nonfood consumer goods was to increase by 35 percent by 1990 and services by 50 percent. During the past two years the authorities have raised the original goals for housing construction, and in 1987 the original target for production of consumer durables was raised. Still, for the most part, planned targets have not been met and the leadership's actions thus far could be characterized as looking for inexpensive ways to improve the consumer's lot. 25X1

To judge from Gosplan Chairman Talyzin's recent speech on the 1988 plan, this "on the cheap" approach to meeting consumer needs may have changed:

- Investment resources allocated to the so-called nonproductive sphere have been increased over that originally called for in the 1986-90 plan. Housing construction, in particular, is to be stepped up and investment going to other consumer-oriented facilities such as preschools, retirement homes, clubs, and theaters is to be raised as well.

- Targets for the production of food, clothing and textiles, and consumer services (including personal care and repair, personal transportation, and recreational services) have also been raised. 25X1

Investment. Meanwhile, the regime's investment policy seems to be largely on track. The 1988 plan calls for new fixed investment to increase by 3.6 percent. Although somewhat lower than the approximately 5-percent annual rate of increase planned for 1986-90, this target is not unreasonable, given the larger-than-average increases in new fixed investment in 1986 and apparently 1987 as well. 25X1

Nevertheless, the plan appears to put inordinate emphasis on a combination of large improvements in the quality of fixed capital and the efficiency with which it is used. The plan implies a sharp reduction in the USSR's incremental capital-output ratio (ICOR)—the increase in productive fixed capital required per unit of growth in Soviet national income. The ICOR 25X1

USSR: Selected Economic Plans and Performance Indicators, 1981-90

Percent

	1981-85 [a]	1986-90 [a b]	1986	1987 [c]	1988 [b]
Gross national product	**1.9**	**3.9**	**3.8**	**1.0 to 1.5**	**4**
Industry	1.9	4.6	3.1	2.0 to 2.5	4.5
Civilian machinery	3.5	7.4 [d]	4.9	1.0 to 1.5	7.1 [d]
Agriculture [e]	2.1	3.3	7.3	−1.0 to 0	3.4
Transportation	2.3	2.3	3.9	NA	NA
Trade	1.6	3.9	−0.2	NA	NA

[a] Average annual growth.
[b] Planned growth based on gross value of output.
[c] Estimate based on nine months of data.
[d] Soviet plan believed to include both civilian and military production.
[e] Net of feed, seed, and waste; includes purchases from outside the sector.

[redacted] 25X1

implied for 1986-90 is much lower than any ratio since the 1960s. This may well be a major flaw in the 1986-90 plan because, we believe, the collection of actions taken to improve the quality of investment or management will not have a large impact during this period. [redacted]

Defense. The published version of the 1988 plan and budget contain almost no information about defense. As usual, the only data provided is the single line entry for defense in the state budget. This figure is the same for 1988 as in the previous year. We believe the budget number is manipulated for propaganda purposes—by Moscow's own admission, it covers only a fraction of total defense spending. Nonetheless, given the regime's investment and consumption goals, unless economic growth in 1988 exceeds this year's lagging pace there will be little room for real growth in defense spending. [redacted]

Implications

Gorbachev may perceive pressing reasons to adhere to his original output targets. Politically, the General Secretary may feel that he is unable to impose plan reductions, given his close association with the 1986-90 plan. At the beginning of the planning period, for example, he remanded the five-year plan to Gosplan for revision before the 27th Party Congress, rejecting at least three drafts as underambitious. More conservative Soviet leaders—Ligachev, for example—have 25X1 warned of the perils of undue haste in implementing Gorbachev's programs, and Gorbachev may be concerned that any retreat from his rapid growth policy might be perceived as an admission that his goals are not attainable. [redacted] 25X1

On economic grounds, as well, Gorbachev may believe that retreat from his original growth targets is inadvisable. Gorbachev realizes that his program for revitalizating the economy depends heavily on the support of workers. Initially, the regime relied on the discipline and antialcohol campaigns to raise worker productivity. Speaking at the June plenum, Gorbachev said that the momentum from these programs 25X1 has been lost. The increased attention being given to the consumer in the 1988 plan seems to be aimed at eliciting the kind of motivated work the regime is counting on as a key element of renewal. In addition, by trying to increase supplies of consumer goods, the Kremlin probably hopes to soak up the excess purchasing power in consumer hands brought about by the reduced availability of alcoholic beverages and to quiet public discontent over other aspects of his program. 25X1

Whatever Gorbachev's motives, the limited data released on the 1988 plan strongly suggest that he intends to proceed full bore with the ambitious targets for growth during the current five-year planning period. In our judgment, the consequences of this decision are likely to include a continuation of the sputtering growth and quality control problems that have plagued the economy in 1987. Growth is likely to fall short of the General Secretary's plans and Gorbachev's modernization program—the cornerstone of his policies for improving the performance of the Soviet economy—is going to be delayed and could even fail, unless there is some slackening of the 1986-90 plan targets. 25X1

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Japan: Fiscal Bonanza From NTT Stock Sale [redacted] 25X1

Tokyo's gradual selloff of 10.4 million shares of NTT stock by 1989 is providing substantial short-term gains to the government, which is using the revenues from the privatization of the world's largest telecommunications firm to help stimulate domestic demand and retire government debt. We believe longer term risks—particularly increased volatility on the Tokyo stock market—may, however, overshadow current benefits. Foreign investors, whose participation in the sale is severely limited, will benefit little from the NTT sale but may be affected by the risks. [redacted]

Benefits From the Sale

The Japanese Government's recent sale of 1.95 million shares, which represents the second of a planned eight-part selloff of two-thirds—or 10.4 million shares—of Tokyo's ownership of NTT, brought in nearly $40 billion. After the last portion of the stock sale is completed in 1989, the government will continue to retain one-third of NTT's outstanding stock. [redacted]

The NTT stock sales, along with the selloff of Japan Airlines stock, will help Tokyo stimulate domestic demand without adding to the budget deficit. As the principal recipient of most of the revenues, Tokyo will use roughly one-fourth of the $40 billion from the recent sale to finance Japanese fiscal 1988 public works expenditures—18 percent of the total public works budget—and the balance to retire government debt. As a result, government interest payments could decline by as much as $1.5 billion, which would trim annual government expenditures by 0.5 percent. The remainder of the public works budget—a key part of Tokyo's much vaunted $44 billion domestic demand expansion program—will be financed with construction bonds. [redacted]

The Japanese financial services industry, in particular, the large securities houses, also is profiting significantly from the government's sale. The lack of any competitive bidding for underwriting NTT shares, the limitation on foreign involvement, and the continued use of fixed underwriting fees, are ensuring large revenues for participating securities firms, according to press reports. We estimate the revenue from this part of the sale to the four largest securities houses, which alone are underwriting nearly 50 percent of the sale, to be around $400 million. [redacted] 25X1

The Tokyo Stock Exchange itself is benefiting from the NTT sale. Most important, the NTT sale has 25X1
encouraged over 1 million Japanese individuals to become, for the first time, active participants in a market traditionally considered too speculative to risk private savings, according to press reporting. Indeed, the government's continued partial ownership of NTT along with the firm's pervasive role in Japan provide Japanese investors enough confidence to invest in NTT shares. In addition, the size of the stock sale, the largest single issue ever on any stock exchange, is increasing both the size of the exchange and the level of activity. [redacted] 25X1
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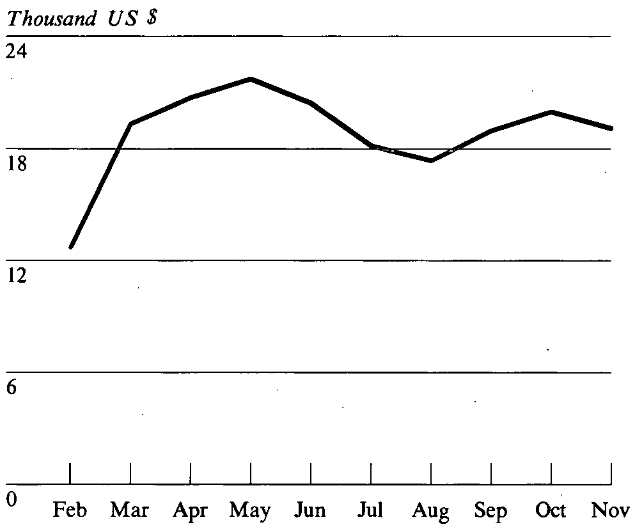
Opportunities for foreign buyers and underwriters, on the other hand, are being severely limited. Foreign securities firms may participate in the sale on behalf of Japanese buyers, but their portion of the 1.95 million shares being sold is restricted to no more than 87,000 shares. Tokyo is prohibiting foreign investors from purchasing NTT shares because of national security concerns of losing control of the telecommunications sector [redacted] 25X1
In comparison, when the Thatcher 25X1
government sold off 51 percent of British Telecom in 1984, Japanese investors alone purchased approximately 6 percent of the stock offered. Moreover, 25X1
British Telcom and AT&T are currently planning to be listed on the Tokyo Stock Exchange to facilitate Japanese investor trading. [redacted] 25X1

NTT: Average Price per Share, 1987



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Strong Demand for NTT Stock

The price of NTT stock has risen far beyond market analysts' expectations, nearly doubling only two weeks after the first sale last February. Indeed, the strong demand has helped keep the price steady despite the recent stock market crash. For example, the NTT stock price declined only 10 percent from its 16 October price compared with a 20-percent decline for the market as a whole. According to various press reporting, the high demand is being spurred by certain investor groups including:

- Institutional investors such as insurance companies and trust banks, who believe significant capital gains will accrue from holding NTT shares.
- Corporations, particularly potential NTT suppliers, that hope to use nominal ownership in NTT as leverage to gain future business.
- Individuals, awash with cash and few investment alternatives, see NTT stock as safer than other stocks because NTT, as a firm that operates only in Japan, is sheltered from fluctuating exchange rates and foreign competition.

In addition, the rapid rise in the share price after the first sale is attracting numerous speculators seeking similar short-term gains again. [redacted] 25X1

This high demand, in our view, is causing a significant overvaluation of NTT shares as well as magnifying the profits for the Japanese Government and underwriters. For example, NTT's current price-earnings ratio—an indication of a firm's potential earnings—is greater than 250, four to five times greater than the average ratios of most Japanese companies. Indeed, the actual performance of NTT appears to be of limited concern to investors. On the day after NTT reported a 10-percent decline in profits for 1987, for example, its per share price on the Tokyo Stock Exchange actually rose by $560, according to press reports. [redacted] 25X1

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Outlook

Tokyo will receive a windfall of an estimated $300 billion by the time the NTT selloff is completed in 1989. This money will allow Tokyo to increase government spending while hewing to its policy of fiscal austerity. The government probably will continue to divide the revenues between public-works spending and debt retirement. Tokyo will be able to adhere to its promise to cease issuing debt to finance government expenditures by 1990 and still be able to provide funding for porkbarrel projects politicians have been requesting. [redacted] 25X1

Despite the many benefits from the NTT stock sale, we believe there are some potential downside risks as well. In our view, there is potential for greater stock market instability because of the vast size of NTT and the stock's inflated value. The dominance of NTT on the Tokyo Stock Exchange—nearly 15 percent of the total capitalization of the first tier[1] of the exchange—is likely to produce a much greater impact on the exchange than the price fluctuations of shares of the largest firms on other stock exchanges. A rapid selloff by the large number of individual shareholders who are inexperienced in the market, could pose additional problems for the stock exchange. [redacted] 25X1

Tokyo is concerned that the overvaluation of NTT stock may contribute to renewed inflation as well as trigger a rise in interest rates, according to press reporting. In anticipation, the Ministry of Finance has undertaken certain measures to limit fluctuations in the NTT share price including requiring cash payments by investors at the time of purchase and prohibiting securities firms from trading from their personal accounts. [redacted] 25X1

[1] The Tokyo Stock Exchange is broken down into three tiers, the first consists of the 225 largest firms on the exchange, which are used to determine the Nikkei average. [redacted] 25X1

[redacted] 25X1

Japan: NTT Operating in a New Environment 25X1

Nippon Telegraph and Telephone (NTT) is responding to the end of its monopoly and privatization by exploring new lines of business. In particular, NTT plans to make a major effort to integrate information services and to explore such diverse ventures as computer security and car rentals. Nevertheless, NTT's newfound requirement to carefully protect its bottom line has not led it to procure equipment from abroad. Preexisting relations with other Japanese firms are hampering foreign competition for NTT's business. Foreign firms interested in filling NTT's and the new carriers' equipment needs will probably have to continue to rely on government-to-government pressure to increase trade opportunities, but such pressure will probably become less effective as Tokyo's stake in the company declines. 25X1

Two Important Changes in NTT Status

In 1984 the Diet passed the Nippon Telegraph and Telephone Company Law, initiating the privatization process and enabling the government to sell its stock over several years to the Japanese public. Two major restrictions on the privatization are that the government always retain one-third ownership and that no foreign entity be permitted to purchase shares of NTT. 25X1

The Diet also ended NTT's telephone monopoly and brought competition to Japan's domestic telecommunications business by enacting the Telecommunications Business Law. Two forms of telecommunications carrier competition now are permitted in Japan. Type One carriers may construct and own their alternative networks and charge competitive tariffs for telephone and data services. Foreign participation in these direct competitors is limited to one-third ownership, and each entrant must be licensed by the Ministry of Posts and Telecommunications (MPT). So far, six competitors have been licensed by MPT to operate domestically—four to construct land lines and two to operate satellites. Type Two competitors rent their telecommunications facilities from Type One carriers and resell telephone circuits to the public. Foreign participation in Type Two carriers is unlimited, and only registration of the company with MPT is required. 25X1 25X1 25X1

NTT's Response

Since April 1985, NTT has explored new lines of business in an effort to diversify away from telephone service—some 90 percent of current revenues. NTT's status as a semiprivate firm has reduced many of the governmental restrictions—such as an excessive employment burden [1]—that applied to the former public corporation. Now NTT is free to focus the firm and its vast research resources on profitmaking products and services. It may not, however, engage in manufacturing, or carry international traffic.

A key part of NTT's strategy and its plans for leading Japan into the "Information Age" is its $135 billion Information Network System (INS). Over the next decade, INS would integrate a wide range of information services such as electronic mail, telephone, high-definition television, facsimile, business data, and transaction services into a nationwide, fully digital network. Japanese technical journals report that most of the research for INS is being conducted by NTT in concert with its family firms—NEC, Fujitsu, Hitachi, and Oki. We believe NTT's suppliers, over the long run, will gain an expertise in developing and integrating information systems that will help establish them firmly in export markets. To date, there has been only limited foreign collaboration with NTT on its INS project. 25X1

NTT is also forming numerous subsidiaries and joint ventures to explore new competitive areas that will help absorb excess employees. 25X1 25X1

[1] In 1987, NTT undertook a manpower reduction program to reduce employment from 330,000 to 280,000 by 1991.

Japan: NTT Enterprises Established in Fiscal 1986 [a]

		Capitalization (*Thousand US $*)	NTT's Share (*Percent*)
Regional companies	Industrial Development Laboratory Corp.	41	9.1
	CAPTAIN Aomori Corp.	593	7.5
	Kurume-Tosu Wide Area Information Co.	370	5.0
	Information Network Fukushima Co.	1,333	0.6
	CAPTAIN Yamagata Co.	593	6.0
	Kitakyushu Information Plaza Co.	741	10.0
Technology/service companies	Internetwork, Inc.	29,630	25.0
	NTT PC Communications, Inc.	10,370	90.0
	Nippon Information and Communication Corp.	17,778	50.0
	NTT Kyushu Telecontrol Planning Co.	741	80.0
	Nishi-Nippon Information Service Center Co., Ltd.	222	10.0
	NTT System Technologies Co., Ltd.	741	100.0
	INS Engineering Corp.	3,696	33.5
	NTT Software Corp.	1,482	100.0
	NTT Syscom, Inc.	148	51.0
	Nippon Computer Security Corp.	2,593	45.0
	NTT Tokyo Software Supply Co.	370	100.0
	NTT System Service Co.	518	90.0
	Nippon Telematique, Inc.	2,222	50.0
	NTT Chugoku Media Supply Co.	185	35.0
	Nippon Telemedia Service, Inc.	1,482	15.0
	Hokuriku CAPTAIN Service Co.	222	40.0
	General Communications Engineering Co., Ltd.	148	50.0
	InfoCom Research, Inc.	1,185	50.9
	NTT International Corp.	22,222	52.8
	Advanced Technology Research Institute, Int.	2,746	54.0
Outside interests	NTT Leasing Co., Ltd.	1,852	40.4
	NTT Rental Engineering Co., Ltd.	2,815	48.0
	Kansai Teleca Co., Ltd.	222	50.0
	NTT Ad Co.	370	75.0
	NTT Travel Service Co., Ltd.	296	25.0
	Japan Utility Subway Co.	7,407	39.5
	Le Parc Co.	148	90.0
	NTT Urban Development Co., Ltd.	22,541	100.0
	Dynamic Admedia	148	85.0
	NTT Legato Co., Ltd.	370	100.0
	NTT Telemarketing Co., Ltd.	370	45.0

[a] Data for fiscal period beginning in April.

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Services. We estimate that about half of NTT's new business activities are in nontelephone services that range from computer security to videotex. In 1986, IBM Japan and NTT formed a joint venture to combine computer processing services with communications capabilities for business needs. The types of services offered may include inventory management, bank and sales transactions, data retrieval services, and claim processing capability. NTT has also established several consulting businesses. One, called NTT International, helps developing nations plan and install telecommunications networks. [redacted]

Technology/Equipment. The Japanese press reports that this year NTT and Corning Glass Works announced a joint optical-fiber development project. The two are sharing research on fluoride fiber—believed to be more efficient than current quartz-based fiber—but applications are probably a long way off. Corning will help market any products in the United States that come from the cooperation. [redacted]

Outside Interests. The Japanese press reports that in 1987 NTT began a car rental business to take advantage of its nationwide sales force and large number of vehicles in NTT's possession. Auto leasing will provide employment for telephone operators displaced from the telephone business. NTT also has travel service and urban development subsidiaries. [redacted]

Privatization and Procurement: Small Gains for Foreign Firms

Since privatization, foreign equipment vendors have not made substantial gains as suppliers to either NTT or the new common carriers. Many industry observers believed NTT might begin to consider cost as a priority in equipment procurement, thereby widening the possible supplier circle beyond the traditional Japanese vendors. Trade statistics indicate, however, that foreign procurement constitutes only about 5 percent of the $5 billion NTT spends annually, with some 90 percent coming from the United States. [redacted] 25X1

When NTT purchases from abroad, the equipment is usually for a niche market with strict technology-sharing and in-country presence requirements attached. In 1987, AT&T sold its ATOMICS system to NTT—a network management and diagnostic program. NTT also purchased the source code from AT&T and the two are to market ATOMICS to other Asian telephone administrations. [redacted] 25X1

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To Tokyo's credit, some regulatory changes—including simplified product certification and testing—have made access to the Japanese telecommunications market somewhat easier. Nonetheless, we believe several factors beyond Tokyo's control could impede a foreign vendor's sales success:

- Regulatory and legislative changes in the telecommunications sector have spawned a host of Japanese start-up companies wanting to sell equipment to NTT and others, thereby increasing the competitive field for foreign manufacturers. 25X1

- Foreign firms are still viewed as threats to the family of NTT suppliers. [redacted] 25X1

- The Japanese traditions of longstanding association and proper introductions, combined with close scrutiny of foreign technology, work against newcomers to the telecommunications market. Northern Telecom, for example, spent four years attempting to sell in Japan before it won the large NTT switch contract. [redacted]

Outlook

We believe Tokyo has recognized the spread of telecommunications competition worldwide, and the necessity of encouraging competitive firms domestically. The dual implementation of privatization and competition effectively permits NTT a freer hand in a difficult marketplace. In our view, NTT's reorganization and rapid diversification will allow the firm to grow, despite the entry of new competitors into NTT's main line of business—telephone service—and despite its two main legal prohibitions—manufacturing and carrying international traffic. The Diet has reserved the option of periodically reviewing these restrictions in order to adjust the regulations that continue to govern NTT. Moreover, NTT's INS plan to integrate digital technology into Japan's national network in the 1990s should keep NTT at the commercial and technological forefront of the telecommunications industry. [redacted]

We believe the high value the Japanese place on longstanding personal relationships will continue to necessitate an in-country presence for foreign firms intent on selling. NTT does not appear to have significantly altered the procurement practices of its monopoly days and close, preexisting relationships with NEC, Hitachi, Fujitsu, Oki, and others, will continue to make competition for NTT business difficult. [redacted] 25X1 25X1

The prospects for continued opening of the Japanese telecommunications equipment market are not promising. [redacted] Tokyo is likely to highlight the high failure rate of US firms in the Japanese market as evidence of unreliability. The best hope for significant purchases of foreign telecommunications equipment is continuing yen appreciation. Politically, Tokyo still seems vulnerable to the argument that Japanese telecommunications firms are doing well in the open US equipment market. We believe that Prime Minister Takeshita—whose power base includes the telecommunications industry—may be able to effect compromises that will marginally improve telecommuncations market access, but he is unlikely to be any more forthcoming than his predecessor. [redacted] 25X1

[redacted] 25X1

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Peru: Dwindling Oil Surplus

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Lima's failure to adopt a comprehensive petroleum policy has led to steadily falling oil production and exports, which is contributing to serious foreign payments problems. Unless President Garcia takes the politically difficult steps necessary to encourage foreign investment in the oil and gas sector, Peru could become a net oil importer by 1989, which would limit economic growth and add to President Garcia's growing political problems. Because of the nationalization of Belco, a US-owned petroleum company, in 1985—which still has not been settled financially—foreign oil companies are awaiting passage of pending petroleum legislation before seeking investments in Peru's promising oil regions.

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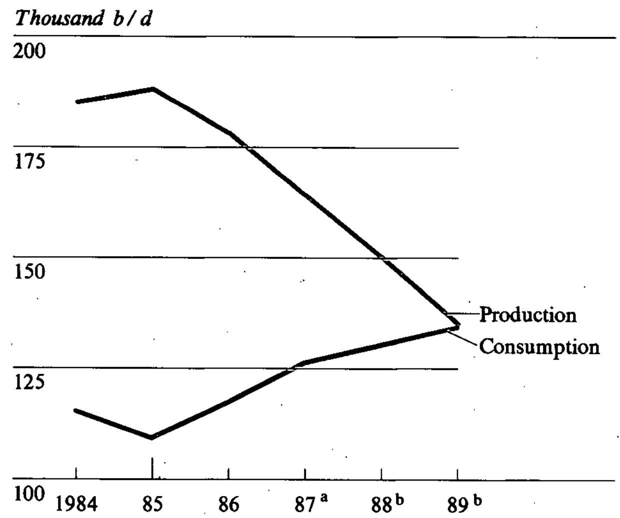
The Worsening Oil Equation

The Garcia administration's growth policies have not been matched by measures to boost Peru's sagging oil production, and, as a result, the country's once ample oil surplus has contracted rapidly. In 1986, for example, big wage increases helped boost real GDP by 8.5 percent and domestic oil consumption rose 7.3 percent, but domestic oil production dropped 5.3 percent, leading to a 13-percent cutback in oil export volume. This year, although economic growth has slowed, domestic oil use rose 11 percent during the first 8 months, compared with the same period last year, while production dropped another 5 percent. In addition, although Peru remains a net oil exporter, imports of petroleum products have more than doubled, and, for the first time since 1978, Peru has had to import crude oil. As a result, the country's net exports of crude oil and petroleum products were down 36 percent during January-August 1987 to 40,000 b/d per day.

We estimate the value of oil exports this year will reach $310 million—up about 30 percent compared with last year—but oil imports will triple this year to $100 million if recent trends continue. This will leave

Peru: Crude Oil Production and Consumption Trends, 1984-89



a Estimated.
b Projected.

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Peru with net oil earnings about the same as in 1986—and $430 million lower than in 1985, when oil was by far Peru's biggest export earner.

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Exploration Lagging

Negative trends in the industry are not likely to be reversed soon, because of the lagging pace of oil exploration. We estimate that oil reserves will drop below 470 million barrels by the end of 1987—equal to about eight years of production at current rates of output. Industry experts estimate that Peru needs to

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Peru's Oil Industry

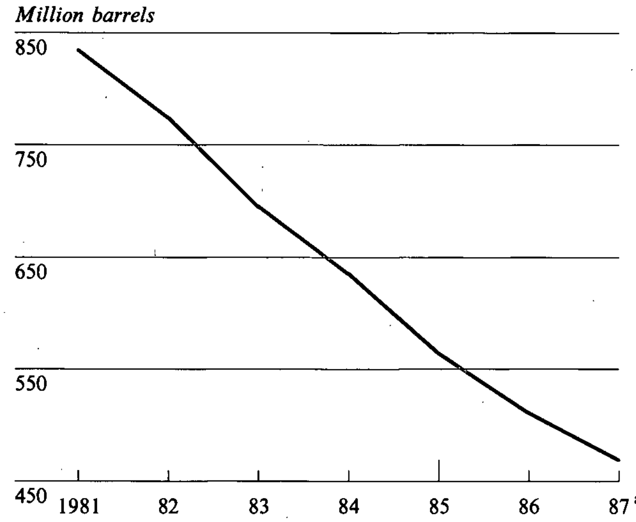
All oil and gas activities in Peru are controlled by the state-owned Petroperu, which is subordinate to the Ministry of Energy and Mines. Petroperu negotiates contracts with foreign oil companies, and all oil producers must sell their output to Petroperu. In September 1987, when Peru pumped an average of 161,000 b/d, production was distributed as follows:

	Percent
Petroperu	*34.7*
Petromar (subsidiary of Petroperu)	*14.5*
Foreign oil companies	*50.8*

Petroperu also operates the country's five refineries, with a total capacity of 180,500 b/d. Because of the slippage in domestic oil production and the increasing share of heavier crudes, these refineries have been unable to satisfy domestic requirements for some petroleum products. To alleviate shortages, Peru has had to increase imports of certain petroleum products and light crudes from Ecuador in order to satisfy refinery needs. Plans to convert 100,000 b/d of capacity to improve the yield from heavier crudes are on hold because they depend on World Bank financing. Peru was cut off from World Bank lending in May 1987 when Lima failed to clear payment arrearages.

[redacted]

Peru: Crude Oil Reserves, 1981-87



[a] Estimated.

[redacted] 314986 12-87 25X1

invest $2.8 billion over the next 10 years in order to reestablish the healthy 10:1 reserves-to-production ratio last achieved in 1983. Much of this investment will have to come from foreign sources, given the inadequate foreign exchange reserves and lack of domestic technical capabilities. [redacted]

This year exploration activity has diminished. In August the head of Petroperu told the press that his public corporation had scaled back its exploration activities because Lima was diverting Petroperu funds to finance other economic programs. He also complained that exploratory drilling in Peru was at a standstill; that month Shell Oil announced it had fulfilled its multiyear contract for exploration. The remaining major US oil firm operating in Peru—which produces almost half of Peru's oil—however, told the US Embassy recently that it is continuing exploration in one of Peru's oil blocks, as called for in its contract, but as yet had not made a commercial find. [redacted] 25X1 25X1

Without increased exploration Peru will become a net oil importer within the next few years. At an engineering conference held in Lima this fall, a local representative of a US company stated publicly that, if the government fails to move quickly to encourage exploration, Peru will be a net oil importer by 1989. Although Peru's Energy Minister quickly refuted this assertion, recent trends support the projection. Oil production is now more than 20 percent below the 200,000 b/d produced when Garcia took office in July 1985. [redacted] 25X1 25X1

Big Natural Gas Find

In late 1986 while exploring for oil, Shell's Peruvian subsidiary made a major gas find in the jungle, 290 kilometers east of Lima. The deposit contains 7-10 trillion cubic feet of gas, making Peru third in South America—behind Venezuela and Argentina—in gas reserves. In terms of energy content, the deposit is equivalent to at least double Peru's oil reserves. If exploited, the gas could displace 35,000 b/d of oil, according to Shell, thus freeing this amount of oil for export. Several foreign companies, including Shell, are interested in exploiting the field, as is Petroperu. Cost estimates for the project range from $700 million to $1 billion, depending on various options, including a possible pipeline to Brazil. Given Peru's poor relations with its creditors and the absence of energy legislation, however, arranging a financing package will be difficult. [redacted]

Inadequate Oil Policies

Garcia's first major oil policy measure—the expropriation in December 1985 of Belco, a formerly US-owned subsidiary involved in offshore oil production—lingers as a deterrent to foreign investment in Peru's oil and other industries. Despite repeated high-level assurances that the matter would be expedited, Lima has yet to affix a value to the expropriated assets, much less compensate the parent company. Prospective foreign investors in the energy sector have repeatedly cited the need for Lima to settle the matter. [redacted]

Despite the efforts of senior Peruvian and foreign oil officials to raise alarms about the deteriorating state of the industry, the Garcia administration has only recently taken tentative steps toward a solution. In November, Lima modified its ban on profit and loan remittances in response to complaints by the US oil company operating in Peru that it could not pay its overseas creditors, according to the US Embassy. In addition, the government is now pushing forward petroleum legislation that includes promises to provide improved financial rewards for oil investments in Peru. According to the US Embassy, the Energy Minister and several congressmen from the ruling party have gotten behind the bill and introduced modifications they hope will allow Peru to compete with Ecuador and Colombia for investment dollars. In mid-November, the legislation passed the Senate, and it is now before the Chamber of Deputies, where the ruling party holds a much larger majority. [redacted]

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Several policies make day-to-day operations in Peru difficult for foreign and domestic oil firms:

- Oil companies must exchange their dollar earnings at the lowest exchange rate prevailing for exports.
- Imports of basic oil field supplies and equipment are delayed by a lengthy approval system designed to ration foreign exchange, which often leads to production losses.
- Several ministries overlap in financial and legal questions related to foreign involvement in the industry, leaving firms with considerable doubts about their ability to operate profitably. 25X1
- Controls on domestic petroleum product prices have squeezed Petroperu profits, and, in 1986, Lima raised the share of the sales price that goes to taxes. [redacted] 25X1

Even if the oil legislation passes, the US concessionaire still has concerns about Peru's bureaucracy. The company has repeatedly requested that Lima reduce the bureaucratic hurdles and financial impediments to its operations. Earlier this year the company told the US Embassy that senior corporate officials of the parent company were considering pulling out of Peru, and more recently, the company began scaling down operations out of frustration with Lima's inaction. The company sees the recent liberalization on profit remittances as a positive gesture, but is waiting to see how the bureaucracy acts on its other concerns. Moreover, Garcia's nationalization of remaining private domestic financial firms in October has made foreign firms wary of investing in Peru. [redacted] 25X1

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Outlook

Recent actions to improve the climate for investment in Peru's energy sector suggest that the government is becoming concerned about the oil problem. Nonetheless, President Garcia, who continues to dominate the political scene, has yet to take a firm stand on energy matters. He probably wants to avoid making major concessions to foreign oil companies because this would be seen as a reversal of his nationalistic economic policies and earn him the wrath of the potent political left. As a result, we expect Garcia to try, at best, a gradualist approach that is unlikely to elicit a sufficient investment flow.

Without firm action to speed exploration and extraction, the deteriorating oil account will exacerbate Peru's foreign exchange woes. Lima expects its net foreign exchange reserves to drop below $200 million by the end of this year—the lowest since 1978—and outside observers project a foreign exchange crisis as soon as next spring. If the US-owned oil subsidiary is unable to gain satisfaction from Lima and continues to allow production to fall, the foreign exchange squeeze will come sooner.

Even if Lima acts to head off the immediate threat of a loss of production and exports, a steady deterioration in the oil trade in 1988-89 will increasingly act as a brake on economic growth. In the first instance, the dwindling foreign exchange earnings from oil will force Lima to strengthen controls on imports, most of which are needed as inputs to domestic industry. Eventually, Lima will have to introduce serious energy conservation measures that are almost certain to slow manufacturing growth because households are not a major factor in energy consumption. 25X1

The neglect of the energy sector, once it becomes a prominent problem, will also add to Garcia's growing political difficulties, spawned by the slowing economy and the expanding insurgencies. Although Peru's predominantly leftist electorate would not support a major intrusion of foreign oil companies, Garcia's inability to make his statist oil policies work will be seen as another failure of the government. 25X1

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International Financial Situation: Update on LDC Debt [redacted] 25X1

Developments in LDC debt situations focus on the following countries:

- ***Brazil***'s Bank Advisory Committee (BAC) continues to experience problems in arranging the $3 billion bank contribution to the $4.5 billion bridge loan announced early last month. [redacted] 25X1 The BAC typically encounters difficulties lining up regional banks for new money packages, but expects to obtain their participation by early next week. [redacted] 25X1 Brasilia will not lift the moratorium until new financing is received in mid-1988. Brasilia had earlier indicated it would resume payments on a normal basis in January. Meanwhile, negotiations for the longer term debt rescheduling package began on 1 December. [redacted] 25X1

- ***Peru*** is stepping up its diplomatic efforts in order to improve its relations with major foreign creditors, but Lima's ability to repay its debts is steadily dwindling and the government's promised economic reform program is likely to be watered down. Minister of Economics and Finance Saberbein met with World Bank and Paris Club officials in mid-November to discuss Lima's plans to improve its debt servicing and change its growth strategy. Although Saberbein did not make any concrete proposals on debt servicing to the Paris Club, he told the group that by moving away from consumer-led growth to a strategy based on exports and investment—including foreign investment—Peru's hard currency earnings would increase. His discussion with the World Bank encouraged the Bank to send a team to Lima for three weeks to examine projects that would aid the export sector. Peru owes the Bank $150 million, however, and with foreign exchange reserves dwindling, Lima will want assurances that major loan disbursements are in the offing before it clears its arrearages. Meanwhile, Lima's promised economic reforms will have to meet President Garcia's dictum that they promote growth, according to Saberbein, and he told the US Embassy that this already rules out the adoption of market interest rates. [redacted] 25X1

Key LDC Debtors: Economic/Financial Indicators

	Foreign Debt [a] *(billion US $)*	Months of Import Coverage by Reserves [b]	Other Indicators
Brazil	114	3.3 (Jul 87) 1.9 (Apr 87)	**Inflation in November was 12.8 percent, year-to-date inflation reached 308 percent; October trade surplus $1.2 billion.**
Mexico	108	17.0 (Jul 87) 10.2 (Apr 87)	**Peso strengthened slightly against the dollar early this week after registering 40-percent decline since 18 November devaluation.**
Argentina	51	**3.0 (end-Nov 87)** 2.8 (Jun 87)	Wage and price freeze should enable government to at least halve inflation in November from the 19.5 percent recorded in October.
Venezuela	31	8.7 (Aug 87) 7.1 (Mar 87)	Caracas revising 1988 budget; 20-percent drop in government investment spending will help reduce budget deficit by 38 percent.
Indonesia	39	8.7 (Dec 86) [c] 10.3 (Sep 86)	**Foreign exchange reserves fell from $10 billion to about $6 billion as of mid-October, nonoil/gas exports during first seven months of 1987 rose 14 percent compared with same period last year.**
Egypt	31	1.5 (Apr 87) 1.4 (Jan 87)	**Cairo is implementing second phase of its strategy to consolidate commercial bank exchange rates by the end of the year.**
Philippines	29	3.2 (Jun 87) 3.7 (Mar 87)	**GNP rose 5.5 percent, exports fell 6.4 percent, and imports increased 16.3 percent during first nine months of 1987; House of Representatives approved $8.3 billion budget for 1988.**
Chile	20	8.4 (Jun 87) 7.6 (Mar 87)	Annual inflation rate in October was 18.8 percent, well above Santiago's 15-to-17-percent target; $742 million January-September trade surplus is approaching IMF's $950 million target.
Nigeria	22	1.0 (Jun 87) 0.9 (Feb 87)	Shortfall in oil revenues contributed to budget deficit of about $3.7 billion for first-half 1987.
Peru	**15**	2.3 (Sep 87) 3.7 (Feb 87)	Trade deficit was $86 million during first eight months of 1987 compared with $340 million surplus for same period last year.

[a] Yearend 1986.
[b] Derived from the ratio of foreign exchange reserves, excluding gold, to imports.
[c] Foreign reserves, excluding gold, plus net foreign assets of commercial banks used in deriving months of import coverage.

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Boldface indicates change over the previous update

Status of Debtor-Creditor Relations	Domestic Political Scene
IMF mission arrived last week to review economic program; formal negotiations for a standby agreement not expected to begin before January.	**Full debate on draft constitution—which contains several nationalist economic provisions inimical to US interests—to begin 13 December.**
Salinas's tough stance with creditors as Budget Minister likely to carry over if he becomes President; Mexico probably will not need new money next year.	**Salinas publicly avoiding the exchange rate issue;** [redacted] 25X1
Buenos Aires wants to negotiate a new debt accord with banks; needs fresh funds to help fill a financing gap of at least $1.6 billion.	Congress unlikely to pass tax package—badly needed to meet IMF targets on deficit reduction—before early next year.
[redacted]	**Eduardo Fernandez nominated as presidential candidate of COPEI, Venezuela's main opposition party, for December 1988 election; running against former President Perez; election probably will focus on political reform and ways to reverse economic stagnation.** 25X1
Undrawn standby loans total about $2.3 billion, but several credits expire soon; Jakarta may seek $300 million loan in early 1988.	**Recent demonstrations indicate growing student activism concerning regime corruption and the national lottery.**
Egypt agreed to reschedule $520 million of its debt to West Germany, failed to reach agreement on debt rescheduling with Australia, and began talks with Spain to reschedule government debt.	Decision by most moderate Arab states to restore diplomatic relations with Egypt is major political success for Mubarak.
Finance Secretary-designate Jayme said he expects debt restructuring agreements with foreign creditor banks will be completed by 22 December but hinted that Manila may reexamine the agreements once they have been signed.	**Recently approved military pay increase, scheduled to appear in paychecks on 15 December, should ease military discontent with the government; security concerns remain high during planning for mid-December ASEAN summit in Manila.**
World Bank Executive Board scheduled to vote on Chile's third structural adjustment loan in mid-December.	Military junta rejected Pinochet's proposal to schedule plebiscite early rather than late next year; moderate opposition continues its campaign against him.
Nigeria signed agreement with the London Club last week to reschedule $4 billion of 1986-87 commercial debt, freeing disbursement of $320 million in new money.	Local elections scheduled this month, not engendering much enthusiasm; first step in transition to civilian rule.
[redacted]	**President Garcia reportedly is pursuing his goal of becoming president of the Non-Aligned Movement; invited a group of Third World leaders to Lima for a summit on debt issues in early 1988.** 25X1

Debt-Equity Swaps: Limited Prospects in Early 1988

Strict regulations and political and economic uncertainty in several key debtor countries bode ill for an increase in debt conversions over the next several months, in our judgment:

- ***Mexico*** suspended swaps last month and may decide to slow down, limit, or even cancel the program next year, according to the US Embassy. Presidential candidate Salinas—who has never been supportive of the program—reportedly requested the suspension, citing the swaps' inflationary impact on the economy.

- ***Brazil's*** National Monetary Council—after months of inaction—approved a debt-conversion program last week, but legislators from the majority party vowed to fight the measure. Moreover, the success of the swap program will depend on how the Central Bank sets discounts for auctions and on the commercial banks' willingness to convert the debts they hold into government bonds.

- In the ***Philippines***, a logjam at the Central Bank—only \$253 million out of \$1.3 billion in swap applications had been approved as of mid-October—a substantial increase in fees on conversions, the chronically uncertain political climate, and an increase in urban violence has discouraged investors.

- ***Chile***, in an attempt to benefit from the steep discount of its debt in the secondary market—also has tightened the terms of its program, according to press reports. 25X1

Even Latin debtors that have loosened the strings attached to their conversion programs face obstacles in attracting investors. ***Venezuela*** has agreed to pay full face value for its debt—the current secondary market price is about 50 percent—but its requirement that swaps be made at the official exchange rate is still a deterrent. Only one debt swap, worth \$5 million, has been approved since regulations were enacted last April. ***Argentina*** has dropped its requirement that investors match converted debt with new money and has agreed to convert debt at the new free exchange rate. Nonetheless, the US Embassy reports that international bankers believe the government remains generally opposed to making the new program work successfully. 25X1

A number of other recent developments could also pose problems for debt-equity swap programs. Foreign investors were dealt a substantial blow when world stock markets crashed in October and may decide to cancel or postpone investment in LDCs because of cash shortages. The prices of LDC debt on the secondary market have dropped as much as 40 percent in the past six months. International banks, who also sustained losses because of the stock markets' plunge, may be less willing now to absorb the losses associated with selling debt at a steep discount. 25X1

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Briefs

Energy

Big Seven Oil Demand Continues To Rise

Oil demand in the Big Seven—which accounts for about 60 percent of non-Communist oil demand—rose by more than 2 percent in first-half 1987, primarily as a result of increased consumption of transportation fuels. Gasoline consumption increased by 2.5 percent over year-earlier levels, offsetting a decline in heavy fuel oil. Continued economic growth and relatively low gasoline prices contributed to the increase. Gasoline consumption in West Germany showed the largest increase—nearly 4 percent—followed by gains in Italy, the United States, Japan, and the United Kingdom. Heavy fuel oil faced stronger competition from cheaper coal and natural gas in most countries. In Italy, however, the shutdown of three nuclear power plants led to a 19-percent increase in heavy fuel oil sales during the first nine months of 1987. Preliminary data for the third quarter suggests oil sales increased about 1 to 2 percent.

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International Finance

Brazil Approves Debt-Equity Program

Brasilia's recently approved regulations for debt-equity conversions are not as restrictive as previous proposals considered by the Central Bank, but numerous problems will probably limit their attractiveness to foreign investors. Under the new rules—to be implemented early next year—debt will be swapped for equity through both auctions by the Central Bank and bonds. Brasilia acknowledges that it intends to gain at least a portion of the secondary market discount—now about 63 percent—for its debt through both mechanisms, but it has not yet indicated if the Central Bank will set a minimum discount in the auctions. Moreover, before conversions can be made through bonds, Brasilia must gain acceptance for this proposal from its commercial bankers in the current debt rescheduling talks—creditors so far have been lukewarm to this scheme. Half of all swaps must involve investments in Brazil's impoverished north and northeastern regions. If enforced, this restriction is likely to significantly check total conversions: few investors are interested in these regions, where infrastructure and skilled labor resources are inadequate. Although the conversion regulations prohibit foreign investors from acquiring controlling interest in Brazilian concerns and from repatriating the investment for 12 years, many legislators, claiming there is still potential for "denationalization," threatened to ban conversions via the new constitution currently being drafted. Foreign bankers and investors, meanwhile, have complained that the new rules are too restrictive. While the new program, once implemented, probably will result in an upswing in conversions from the $200 million annual level of the past two years, the restrictions in the new program, combined with general economic and political difficulties will probably keep conversions well below the $1.5 billion annual level that Brasilia is projecting.

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Mauritanian Debt-Equity Swap

Mauritania and the World Bank have arranged the first debt-equity swap in Africa, according to press reports, involving $18.6 million in debt to Arab, West European, and US banks. Nouakchott will use $5-8 million—the exact amount has not been determined—provided in a World Bank loan to pay cash to creditors and will pay the balance in equity in Mauritania's two largest banks. We believe the swap will strengthen Mauritanian banks and give them increased access to badly needed credit. Furthermore, World Bank participation will make additional planned swaps attractive to creditors—West European bankers have already expressed interest. The deal will almost surely ensure further Bank funding. 25X1

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Senegal Reschedules Debt With Paris Club

Senegal reached agreement last week with the Paris Club to reschedule its $80 million of official debt due next year, according to US Embassy reporting. Dakar has a 16-year repayment period with six years' grace. The creditors reportedly have been satisfied with Senegal's performance under an IMF-backed economic reform program that calls for reduction of subsidies and price controls, privatization of 15 parastatals, and trimming of civil service rolls. Dakar's tight fiscal policies have helped reduce the budget deficit from 8 percent of GDP in 1983 to an estimated 2.3 percent in 1986. The rescheduling agreement probably will ease economic pressures on President Diouf as he campaigns for reelection for a second five-year term in February. 25X1

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Global and Regional Developments

Soviet-Western Petrochemical Joint Venture Announced

The Soviets signed a letter of intent late last month with Occidental Petroleum, Italy's Montedison, and Japan's Marubeni for a $5-6-billion petrochemical joint venture. The complex, to be located near the Tengiz oilfield in Kazakhstan, will use natural gas liquids to produce 500,000 metric tons each of polyethylene and polypropylene annually. The facility also will produce up to 1 million tons of sulfur annually along with other plastic materials. The Western firms will hold 49 percent of the equity in the venture, supply technology, and build and operate the facility. One-half of the output is targeted for export. Construction is scheduled to begin in 1989 with startup in 1992. If the project is built as planned, it will be one of the largest petrochemical plants in the world. 25X1

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New Cuban Aviation Agreements

Havana has recently concluded charter air service agreements with Brazil and the Dominican Republic in an effort to promote tourism. Cuba and Brazil have arranged to begin regular charter service between Havana and Sao Paulo on 11 December 25X1

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Cuban–Dominican Republic agreement signed on 23 November formalizes access for weekly flights, which the US Embassy in Santo Domingo reports will serve as the basis for package tours Cuba plans to offer in other countries. The Santo Domingo and Sao Paulo airlinks are unlikely to significantly increase tourist travel to Cuba. The new routes do, however, offer Havana the political benefit of greater visibility in Latin America, buttressing Cuban efforts to improve ties to other governments in the region. 25X1

Iran Steps Up Economic Aid to Lebanon

[redacted]

Iran is financing a highly visible economic assistance program in Lebanon in order to bolster the Shia community's support for Hizballah and the fundamentalist movement. [redacted] the economic assistance funds are allocated to provide staple foods, subsidized pharmaceuticals, and fuel oil to the poor residents of the Bekaa Valley. Iranian financing allows Hizballah to attract fighters through attractive salaries [redacted] and support families of Hizballah casualties. Financial inducements, combined with Lebanon's economic turmoil, have encouraged increasing numbers of Amal fighters to switch allegiance. As Lebanon's economy deteriorates further, Hizballah will use its relative financial strength to improve its position militarily and broaden support among the hard-pressed Lebanese population. [redacted]

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National Developments

Developed Countries

Japanese Export Price Response to Yen Appreciation

[redacted]

The Japanese Trade Ministry is concerned that the failure of Japanese firms to increase export prices to more fully reflect the yen appreciation could lead to further tensions between Japan and its trading partners. According to IMF data, Japanese companies have increased the dollar price of their exports nearly 40 percent since early 1985—indicating that they have passed through to overseas customers almost half of the 80-percent appreciation of the yen over the same period. This is virtually equivalent to the percentage passthrough during the 1981-82 depreciation of the yen—when Japanese firms cut dollar prices by 11 percent in the face of a 20-percent depreciation of the currency—but is considerably less than the 70-percent passthrough of the 1977-78 appreciation of the yen. In part, we believe that Japanese firms have been more reluctant to pass on the yen appreciation this time because they now face tougher competition—particularly from the Asian NICs—in most export markets. In addition, Japanese firms have been able to afford to hold down the dollar price of exports because profits until recently were being buoyed by the huge capital gains corporations were earning by speculating in financial markets. Since this strategy appears to have been severely curtailed by the recent volatility of financial markets, firms could be forced to further boost the dollar price of exports in coming months. [redacted]

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Tokyo To Increase Tax on Imported Oil in 1988

[redacted]

The Japanese Trade Ministry last week announced a proposed tax increase on imported oil in the fiscal year beginning next April in order to finance an expanding national oil stockpile. MITI officials said the tax hike plan—if approved by the ruling party and Finance Ministry after it is formally submitted in December—will shift the current value-based oil tax system to a volume-based one, a move the Ministry estimates will triple the tax on each kiloliter of oil. MITI [redacted] is forecasting instability in global oil supplies in the next decade [redacted] Domestic industry has consistently opposed energy tax hikes, but with imported oil prices

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falling because of the strong yen, MITI probably views the time as ripe to push through a tax increase. If approved, the hike will probably marginally depress demand for oil, which is already nearly 20 percent below the 1979 peak. 25X1

West German Social Democrats Urge Many Different Stimulus Packages

Slumping growth prospects in West Germany have led many SPD members to urge Bonn to spur the economy, but the broad range of options they have proposed reflects the strong differences that continue to characterize the party's thinking on economic issues. Former Finance Minister Schiller is recommending a more aggressive approach to tax cuts by calling for use of the Stability and Growth Law. This law, which Schiller crafted, enables Bonn to cut taxes by 10 percent across the board. SPD leader Vogel—who had initially opposed lower taxes on the grounds that such a move would increase state budget deficits—has recently supported cuts as a complement to his initial plea for greater government spending at all levels. Other leaders are less precise. Both ex-Chancellor Schmidt and Daimler chief Reuter—expected to be a minister in any future SPD government—avoided specific prescriptions and did not associate themselves with either Schiller or Vogel, but both have urged the Kohl government to show leadership by taking measures to boost growth. 25X1 25X1

Portuguese Tax Reform

The Silva government has introduced a plan in Parliament aimed at simplifying direct taxation as part of its overall program to revamp Portugal's antiquated system of public finances. The proposal replaces Portugal's seven direct taxes—each one connected to a different income source—with only two: an individual and a corporate income tax. Primarily by reducing tax evasion, the government hopes to avoid raising tax rates and still lower its heavy reliance on indirect tax revenues. The plan represents a major step in streamlining Portugal's tax system, but it probably will not take effect for some time. Even if—as is probable—Parliament approves the proposal before the end of the year, the top-heavy Portuguese bureaucracy probably will need substantial time to implement the new taxes. Indeed, we doubt that Lisbon will be able to meet its 1988 target implementation date. 25X1 25X1

Spanish Telecommunications Bill

Spain's draft telecommunications law (LOT) was passed by the Congress of Deputies in late October, but continuing opposition by various interest groups may delay its approval in the Senate until next year. Although in principle the law is a move toward liberalization, most critics claim that the language is too hedged by qualifications and exceptions. The Spanish employers' federation has expressed concern over the limited liberalization of customer premises equipment, and the major industry organizations have called for total deregulation of leased lines and value-added services. Moreover, the proposal is likely to restrict foreign companies' activities in Spain to a 25-percent ownership share in private telecommunications entities. Meanwhile, rightist opposition parties in Congress have objected to provisions calling for central government control over services such as private radiobroadcasting and have threatened to challenge the constitutionality of the LOT if it is passed by the Senate without major changes. 25X1 25X1

Greek Efforts To Promote Exports

Athens is trying to raise the quality of Greek exports in an effort to boost sales to Western markets, especially the United States. The state-owned Hellenic Export Promotion Organization has begun a program to encourage more small and medium-sized Greek businesses to export quality goods, according to press reports, 25X1
in an attempt to improve on a tarnished image—resulting from incidents such as the sale of shoddy footwear to the United States several years ago. The organization is carefully screening potential exporters for competitiveness in quality, pricing, and packaging, and enrolling the best manufacturers in the Institute for Export Training to learn exporting skills, including marketing, the use of banks, transportation, and labeling. Although entry into the EC in 1981 has helped Greece compete with its European neighbors, the country still has trouble meeting the demands of the US market—which accounted for only 7 percent of Athens' exports last year, down from 9 percent in 1981. The program is also further evidence of Prime Minister Papandreou's more conciliatory attitude to business needs in recent months, including promises to lower taxes and change the laws governing the firing of redundant workers. 25X1

Ireland To Ease Foreign Exchange Controls

Dublin recently announced that it will ease foreign exchange regulations on 1 January, its first step in liberalizing capital controls. Finance Minister MacSharry has proposed a series of measures that will allow individual investors to purchase up to $8,000 worth of foreign stocks with an overall cap of $4.8 million, while insti- 25X1
tutions will be able to increase their foreign holdings to 12 percent of their cash flow. Dublin will also increase the limit on the value of property individuals can own outside the EC from $32,000 to $80,000. Other changes include an increase in the personal travel allowance from $800 to $2,000 and elimination of the limit on repatriation of assets by emigrants. The Department of Finance estimates that the new regulations will result in a net currency outflow of about $100 million in 1988. Nevertheless, the liberalization is a necessary start to comply with the EC's requirement to abolish restrictions on cross-border private investment by 1992. 25X1

French Textile Industry Unemployment May Rise

The EC Commission's recent confirmation of a 1985 ruling that a $26 million French textile industry modernization plan violated EC competition rules has raised fears in France of plant closings and higher unemployment. The French textile industry has been buffeted by lower cost overseas competition, reduced 25X1
exports to the United States and the Middle East because of the fall of the US dollar, and the poor performance of its stocks. Many firms need to restructure their operations and may have to lay off some of the industry's 454,000 workers. Mediocre growth prospects, a contracting job market, and close public attention to unemployment figures leave Prime Minister Chirac little room to maneuver. Chirac already faces allegations that the government is underfunding jobs programs in the 1988 budget. Under these conditions, significant additions to unemployment from the textile industry could damage Chirac's electoral chances this spring. Thus, any response to the EC ruling will probably be delayed as long as possible. 25X1

Israel's Trade Deficit Surges

Israel's trade deficit widened to about $2.7 billion in the first 10 months of 1987 compared with $2.0 billion in the same period last year, reflecting a 22-percent increase in imports and a 16-percent increase in exports. The figures contrast sharply with the government's estimates for 1987 in which exports were forecast to increase by 10 percent and imports by 7 percent. In our judgment, rises in real wages and private consumption expenditures, relatively low domestic real interest rates, the redemption of previously frozen bank shares, and the stable exchange rate of the shekel against the dollar have contributed to the rapid import growth, particularly in the last six months. With the larger trade deficit, Israeli exporters probably will intensify their demands for a devaluation, arguing that the pegging of the shekel to a basket of five currencies—a move implemented by the government in August 1986—has harmed exports. While Bank of Israel Governor Michael Bruno remains opposed to a large devaluation, he has left open the possibility of a limited devaluation if Histadrut—the national labor federation—agrees to waive at least part of workers' cost-of-living payments. 25X1

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Australian National Wage Hike

Canberra is supporting labor unions' request for a 1.5 percent wage hike to placate labor leaders and counter the recent upswing in strikes. The small raise would supplement the $7-a-week increase awarded to all workers under the first tier of the two-part wage system implemented last summer. Australian unions are pressing Canberra for the additional wage hike because employers and unions have not yet agreed on the amount of second-tier raises, which are supposed to be based on improved efficiency and production in individual industries. After several months of negotiations, only 10 percent of eligible workers have received second-tier raises, according to US Embassy reporting. Canberra's support for the supplemental increase also follows an embarrassing media brawl between government and national labor leaders over a proposed, but not implemented, 11-percent pay rise for parliamentarians. 25X1

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New Zealand Forms New Labor Council

The almost exclusively Communist leadership of New Zealand's new Council of Trade Unions will probably give strong support to leftist causes and seek affiliation with international leftist labor organizations. The Council represents almost all public and private sector unions in the country and replaces the private sector Federation of Labor, which was disbanded last summer in favor of a more broadly based organization. Former Federation leaders Ken Douglas and Jim Knox have been retained as president and international labor lobbyist, respectively. According to the US Embassy, Douglas is chairman of the small New Zealand Socialist Unity Party and probably is a Soviet agent of influence. The Council probably will not have a major impact on policymaking at the national level for sometime as it is preoccupied with factional maneuvering for influence and the process of building staffs. Moreover, any Council attempt to promulgate stronger socialist economic policies will be hampered by its identification with leftist political parties that do not have representation in the New Zealand Government and by the growing momentum of the Labor Party government's free-market policies. 25X1

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Less Developed Countries

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Iranian Economic Difficulties

Economic hardship in Iran appears to be growing worse as oil revenues drop from last summer's peak. Unemployment and annual rates of inflation of at least 30 percent persist, and shortages of gasoline and heating fuel apparently have increased recently, 25X1 25X1 Power outages in Tehran continue, averaging about six hours a day, and most government employees have second and sometimes third jobs to meet food and housing expenses. 25X1 Early last month officials increased their efforts to counter rising prices and recently announced increased penalties for trading on the black market, according to Iranian press reports. A decline in Iranian oil revenues from a high of $1.2 billion in August to about $800 million last month may force Tehran to reduce civilian imports further. In addition, cold weather is increasing the demand for heating fuel and probably aggravating hoarding. Iranian steps to control inflation and fill shortages are not likely to have much effect, and Tehran may attempt again this winter to divert public attention from austerity to the war with Iraq or to the United States. Nonetheless, economic problems have not yet become as severe as they were last winter and are unlikely to appreciably affect Iran's ability to prosecute the war. 25X1

Opposition Strikes Hurting Bangladesh Economy

Strike-related production losses and flood damage will slow Bangladesh's real GDP growth to roughly 2 percent during the current fiscal year—which began in July—compared with 4 percent last year. Flood damage alone is estimated by the US Embassy at $1 billion, and production losses because of opposition strikes are estimated at $20 million per day by World Bank officials. A state of emergency was imposed last week, at least partially to prevent additional production losses and to prevent disruption of foodgrain distribution. 25X1

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the price of rice has increased by 25 percent compared with that of October because of distribution disruptions and hoarding. Damage to railroads and industrial units from random acts of sabotage amounts to several million dollars. 25X1

Sri Lanka's 1988 Budget To Boost Deficit

Sri Lanka's FY 1988 (January-December) budget reflects both the administration's desire to avoid popular criticism and to provide those affected by the prolonged Tamil insurgency with funds for reconstruction. Government expenditures are expected to reach more than $3 billion—a 16-percent nominal increase over last year—with defense, debt repayment, and social services such as housing and rural development accounting for a significant share of the total. Colombo is reluctant to meet rising government expenditures through major tax hikes, fearing that such increases would aggravate popular dissatisfaction at a time when it is trying to win additional support for the Indo–Sri Lankan peace accord. Colombo plans instead to increase taxes only on luxury consumer goods and to ease export licensing restrictions in order to boost revenue earnings. These measures, however, will not be enough to make up for the loss of funds expected from the budget's proposed income and corporate tax cuts. As a result Colombo's budget deficit is likely to increase dramatically, heightening Sri Lanka's need for international financial support. 25X1

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Zambia's Pro-Western Central Bank Appointment

The appointment of Francis Nkhoma as Governor of the Central Bank on 25 November signals Zambia's renewed interest in cooperation with the World Bank and the IMF, according to the US Embassy. Nkhoma is staunchly pro-Western; his predecessor was a Soviet-trained socialist. The appointment is also a public relations gesture by President Kaunda, we believe, to demonstrate his commitment to economic reform—even though he may find it politically difficult to implement austerity measures before next year's presidential election. An outspoken critic of

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the government's socialist economic policies, Nkhoma publicly advocates budget reductions, diversification away from copper—which accounts for about 90 percent of the country's foreign exchange earnings—and import reductions. Because circumstances are not propitious for economic reform in the short term, we believe Nkhoma is likely to become openly critical of the pace of reform and eventually lose Kaunda's support. 25X1

Dominican Republic's Worsening Electricity Shortage

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Santo Domingo is taking tentative steps to reform the state-owned Dominican Electricity Corporation (CDE), but the measures appear insufficient to resolve the country's worsening shortage of electric power. The traditional practice of Dominican presidents to use the monopoly to reward political supporters with jobs and to subsidize electricity for the poor is largely responsible for the company's problems. Moreover, politically appointed administrators have long neglected routine maintenance and planning to meet future eletricity demands. Over the past few months the company has resorted to rotating daily blackouts in order to compensate for inadequate generator capacity. According to the US Embassy, President Balaguer recently appointed a new CDE administrator, settled a contract dispute with a US firm over the completion of a new thermoelectric plant, and provided funds to rehabilitate an inoperational thermoelectic plant. Despite these measures, the monopoly probably will be unable to meet the growth in the country's demand for electricity over the next decade. Moreover, although Dominican officials believe that some privatization of the company is inevitable, we doubt that such a move is a realistic option, at least over the short term; the company's prolonged unprofitability is unlikely to attract investors. CDE officials have suggested alternatively that private firms build generating plants and sell electricity to CDE, but several private investors have refused the offer, probably because of the monopoly's poor record of paying its bills. 25X1

Persistent shortfalls in generating capacity are likely to contribute to growing social unrest and slower economic growth. We believe that continuing blackouts could spark a resumption of the sometimes violent demonstrations that characterized protests over deteriorating public services in several major cities last summer. 25X1 At a minimum, the problem is likely to hinder the expansion of the Dominican economy's two most dynamic sectors, tourism and industrial free zones.

Afghan Ministry of Transportation Criticized

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The Afghan Communist party central committee recently criticized the Ministry of Transportation for failing to improve Kabul's public transportation system. The need for mass transportation in the capital has increased substantially since the beginning of the war because of the large influx of refugees into the city. The city currently relies entirely on an outdated busing service run by the state-owned Milie Bus Company. Party officials revealed that most parts of the city do not have bus stops and a number of the city's roads are in disrepair. Bus transportation also suffers from some of the same problems as most Afghan industries, including a shortage of spare parts and labor. The regime hopes to solve the transportation problem, in part, by attracting private investment but will probably meet with little success. Although the private sector is heavily involved in transporation—about 70 percent of the transportation industry is privately owned, according to Afghan Government estimates—most Afghan businessmen prefer to invest in trucking where profits are higher. 25X1

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Unification of Egypt's Exchange Rates Continues

Egypt's Minister of Economy Mustafa has implemented the next stage of Cairo's strategy to consolidate exchange rates—six weeks in advance of the target date set in May in the government's standby agreement with the IMF. According to Embassy reporting, the government will value another 40 percent of commercial bank transactions at the new semiflexible rate, which now stands at about 2.2 Egyptian pounds per dollar—63 percent higher than the old commercial bank rate. The transactions affected by the devaluation include payments for government-supplied commodities and public-sector purchases of factor inputs and spare parts as well as receipts from banking commissions and exports. 25X1 25X1

Kuwaiti Securities Issue

Kuwait has begun issuing treasury securities for the first time in order to generate additional revenues. The US Embassy in Kuwait reports that the government plans to raise over $700 million from the sale of short-term bills and medium-term notes by the end of the year. The initial offering on 26 November was heavily over-subscribed by local financial institutions with more than $1.1 billion bid for $400 million in bills, according to the US Embassy. Although primarily a revenue generating measure, Kuwait's move provides a means to tap excess liquidity in the economy generated by investors repatriating funds threatened by the turmoil in foreign financial markets. It also enhances the government's ability to use monetary policy to direct the economy, helps promote development of local capital markets, and reduces the need to draw down government investments that have become increasingly illiquid in recent years. The security offer highlights the growing sophistication of Kuwait's financial planners and probably will serve as a bellwether for other cash-constrained Gulf states. 25X1 25X1

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Soviet Bank Reform To Be Limited

Recent statements by Soviet banking officials indicate that Soviet banking reform will be slow and limited. A July decree creating three commercial banks and revamping the existing three banks emphasizes increasing the use of economic criteria in lending and decentralizing banking operations. As of 1 January 1988, local banks will go to "self-financing," which will stress operating according to profit and loss criteria. These measures are meant to complement the move toward enterprise self-financing and greater economic accountability planned for 1988-89, but actual decentralization of financial decisionmaking over the near term apparently will be small. The officials said that the central bank's control over the banking system will be only gradually lifted in order to minimize disruption. They acknowledged that ruble convertibility, even within CEMA, is a long way off and claimed that there will be no currency reform.

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China's New Management Reform Initiative

Local party officials in the northeastern city of Harbin recently removed party committees from over 600 municipal-run enterprises and factories as well as some schools and hospitals in order to curb party interference in management. Although this move is in keeping with reform efforts to end party meddling in administrative and enterprise affairs, it appears to go much further than General Secretary Zhao Ziyang's proposals at the just-concluded 13th Party Congress. Zhao called only for the transfer of authority over factory committees from state ministerial party committees to local party committees. Harbin, which has been a center of media attention for some time because of its experimentation with political reforms, appears to have taken matters a step further by eliminating party committees altogether from municipal enterprises, a move it would only have taken with the concurrence of national party leaders. Should this latest experiment prove successful in revitalizing local industries, Beijing reform leaders will probably press hard to broaden it to provincial- and state-run enterprises in other regions. More conservative leaders, concerned about the erosion of party power and influence, would undoubtedly seek to stop or at least restrain such a move.

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Shenyang on Leading Edge of Chinese Economic Reform

Shenyang is at the forefront of China's enterprise leasing and bond market reforms, according to the US Consulate in Shenyang. Originally confined to small, bankrupt enterprises, the leasing program now covers nearly 900 firms, some of them medium sized and profitable; China's largest leasing arrangement is the Shenyang automobile corporation with 63 factories and some 50,000 workers. Leasing contracts have given managers more operational independence, greater financial rewards, and potential financial risks. The Shenyang Bond Exchange—China's first bond market—has enjoyed similar success since opening in August 1986 and a secondary market for securities has developed. Most of the bonds are small-denomination, short-term issues by enterprises to finance capital improvements. About 80 percent are "lottery" bonds that offer very low interest rates and a chance to win prizes; the remainder are "financial" bonds—issued mainly by financial institutions, offering a higher return and appealing to more conservative investors. Because of the well-publicized and well-received success of these two reform measures, we expect a continued broadening of the experiments that will maintain Shenyang's position as a reform leader.

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